The New York

Certified Public Accountant

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Published by

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—From the Certificate of Incorporation.

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The New York State Society of Certified Public Accountants

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The NEW YORK CERTIFIED PUBLIC ACCOUNTANT *is published monthly from October to June. Copies may be obtained at the office of the Society at twenty-five cents per copy, $2.00 per year. All other communications relating to this publication should be addressed to the Committee on Publications.*

CURRENT EVENTS

Calendar of Events

May 4 — Regular meeting of the Board of Directors.

May 8—7:45 P. M.—Society Meeting—Subject: To be announced later. Location: Waldorf-Astoria Hotel, Lexington Avenue at 49th Street, New York City.

May 19-20—Four-State Conference—Hotel Claridge, Atlantic City, N. J.

June 2—Sixth Annual Outing, Westchester Country Club, Rye, N. Y.

June 23-24-25—Sixth Regional Chapter Conference, Holl's Inn, Fourth Lake, Inlet, N. Y.

Report of Nominating Committee

Nomination of Victor H. Stempf for the presidency of the Society has been announced by the Committee on Nominations in its report, dated April 6, 1939, which also contained the nominations of four other officers and five members of the Board of Directors:

The report of the Committee, transmitted to the membership by G. Charles Hurdman, secretary of the Society, is as follows:

> Pursuant to Paragraph 4 of Article XI of the By-Laws of The New York State Society of Certified Public Accountants, the Nominating Committee for 1939 offers the following nominations for the several vacancies in the offices and directorships of the Society which are to be filled at its next meeting, to be held in May of 1939 as provided under Paragraph 1 of Article III of the By-Laws:

Officers for One Year:

For President

Victor H. Stempf.....to succeed Morris C. Troper

For First Vice President

A. S. Fedde....to succeed Victor H. Stempf

For Second Vice President

Andrew Stewart....to succeed A. S. Fedde

For Secretary

G. Charles Hurdman....to succeed himself

For Treasurer

Archie F. Reeve..........to succeed himself

Directors for Three Years:

Morris C. Troper......to succeed William H. Bell

Warren W. Nissley....to succeed Samuel J. Broad

Norman Joseph Lenhart to succeed Walter A. Cooper

Saul Levy...............to succeed himself

Frederick W. Wulfing to succeed Ira A. Schur

Respectfully submitted,

COMMITTEE ON NOMINATIONS

(Signed) Walter N. Dean
" Henry A. Horne
" Charles L. Hughes
" Joseph J. Klein
" S. D. Leidesdorf
" John T. Madden
" Henry E. Mendes
" George Cochrane, *Secretary*
" Arthur H. Carter, *Chairman*

Society Leases New Headquarters

It is expected that on or about May 1, 1939, the Society will move its headquarters from its present location to 15 East 41st Street, New York City, between Fifth and Madison Avenues. There it will enjoy larger quarters on the entire fifth floor. It is hoped that the members will visit us in our new home.

The Society's telephone number will be Vanderbilt 6-2765.

Round Table Forums

The first meeting of the third series of round table forums was held on April 5, 1939, and was conducted by the Committee on Consolidations and Reorganizations. This meeting was most successful, having been attended by over 130 members. The five other meetings scheduled of this series, should be of interest to a great many members and will be conducted by the committes listed below:

April 12th—Investment Trusts—Christopher H. Knoll, Chairman.

April 19th—Insurance Companies Accounting—J. B. C. Woods, Chairman.

April 26th—Non-Profit Institutions Accounting — A. F. M. Deutsch, Chairman.

May 3rd—Bank and Trust Company Auditing—Philip S. Suffern, Chairman.

May 10th—Mining and Smelting Accounting—Henry B. Fernald, Chairman.

Plans Nearing Completion for the Sixth Regional Chapter Conference

Plans for the Sixth Regional Chapter Conference to be held this year at Holl's Inn on Fourth Lake, Inlet, New York, on June 23-24-25, 1939, are being rapidly completed.

The program will consist of technical sessions and sports.

Entertainment features of the program will start Friday morning with informal sports and on Saturday morning, competitions for the Hurdman and Hughes trophies in golf and the Troper trophy in tennis will be held. Informal entertainment consisting of boat rides, ping pong, croquet, shuffle board, horseshoe pitching and bridge are available at all times.

Each year the Regional Chapter Conference has become more popular. Holl's Inn offers facilities needed for the conference and has been again selected after a careful investigation of available locations.

Holl's Inn is high in the center of the Adirondack Mountains, 1,750 feet above sea level and dominates a private estate of 140 acres of beautiful forest land. Nearly 2,000 feet of delightful shore front, sandy beach, large screened porch, dining room facing the lake, a spacious lobby and cocktail bar, are the facilities which go to insure a successful meeting and an enjoyable week-end.

Make your reservations early with the Society's office.

Remember the Dates—June 23, 24, and 25, 1939.

Sixth Annual Outing Scheduled

The Sixth Annual Outing and Tournaments of The New York State Society of Certified Public Accountants will be held at the Westchester Country Club, Rye, N. Y., on Friday, June 2, 1939.

The program and reservation cards will be mailed to the members shortly.

Three Times Across the Atlantic

During the short visit from his work abroad Morris C. Troper, President of the Society, told of seeing a member, Roger Boulogne, in his Paris, France office and noted that his membership certificate was one that had traveled across the Atlantic three times. In December the Society's office sent to Mr. Troper, in Paris, a number of certificates to be signed. They were forwarded to Warsaw, Poland and signed there by Mr. Troper, returned to Paris and then to New York. Mr. Boulogne's certificate was then again sent across the Atlantic to Paris where it now has a prominent place in his office.

Eastern Four-State Conference Program Arranged

United States Senator Joseph C. O'Mahoney of Wyoming has been added to the list of speakers for the Eastern Four-States Accounting Conference to be held at the Claridge Hotel in Atlantic City on Friday and Saturday, May 19 and 20 next. The Senator, who is also chairman of the National Temporary Economic Committee, will present an address at the opening session of the conference on the morning of May 19.

As announced earlier, the conference is being held jointly by the New York, Connecticut and New Jersey State Societies of Certified Public Accountants and the Pennsylvania Institute of Certified Public Accountants. The American Institute of Accountants is cooperating actively in conference plans.

The general chairman of the conference will be John A. Conlin, president of the New Jersey Society of Certified Public Accountants. Orin O. Roundy of Newark is chairman of the conference committee. He has announced that conference events will include two luncheons and a closing dinner; two "get-together" breakfasts; two Accounting Clinic sessions and two general sessions.

Willard Thorp, Special Assistant to the Secretary of Commerce, will be a conference speaker, and is scheduled to address the luncheon meeting on Friday, May 19. Henry H. Heimann, executive manager of the National Association of Credit Men and chairman of the Natural Business Year Council, will address the luncheon on Saturday, May 20, and will have "Brakes or Break-up?" as the title of his talk.

A nationally important public figure has been invited to address the conference dinner on Saturday evening, May 20. Maxwell E. McDowell, head of the tax department of the Standard Oil Company of New Jersey, will address a general conference session on the morning of May 20. Walter R. Darby, Commissioner of Local Government of the State of New Jersey, will take part in a discussion of the subject "Municipal Accounting to Safeguard the Public Interest" on that same morning. George P. Ellis, member of the Committee on Government Accounting of the American Institute, will present a paper on "Municipal Accounting."

Other conference speakers will include Victor H. Stempf, acting president of The New York State Society; John L. Carey, secretary of the American Institute of Accountants; J. William Hope, past president of the Connecticut Society of Certified Public Accountants, who will present a paper on "An Accountant's Responsibility to the Public"; Maurice E. Peloubet, Samuel J. Broad, Dr. D. Walter Morton, chairman of the Syracuse Chapter of The New York State Society; D. M. Livingston of Livingston, McDowell and Company, Philadelphia; A. Karl Fischer of Philadelphia; Charles E. Fernald of Philadelphia.

Presiding officers at the conference will include John K. Mathieson of Philadelphia, a vice-president of the American Institute; Guy Cambria, president of the Connecticut Society; Harry Ness, president of the Pennsylvania Institute; C. Whitford McDowell, chairman of the Philadelphia chapter of the Pennsylvania Institute. Chairman Conlin of the conference will preside at the opening session on May 19 and at the closing dinner.

Topics to be discussed at the Eastern Four-States Accounting Conference also will include inventories, accounts receivable, the accountant's certificate, the natural business year; building and loan accounting; accounting problems of public utilities,

and of industrial corporations; problems and procedure in bank auditing. Discussion of these subjects will be divided between the scheduled Accounting Clinic and general sessions.

On behalf of the conference committee, Chairman Roundy has announced that registration at the conference is open to all certified public accountants, and to business executives, bankers, credit men, local government officials, members of the legal profession and others who may be interested. The committee now has in preparation a printed announcement which will give information about registration costs and other details, and which will be mailed to all members of the four cooperating state societies.

Buffalo Chapter Elects Officers

At the annual meeting of the Buffalo Chapter of The New York State Society of Certified Public Accountants held on April 10, 1939, the following officers were elected for the ensuing year:

Edward P. Klingenmeier........*President*
Jerome P. Hausle..........*Vice President*
R. Douglas Campbell...........*Treasurer*
Benjamin Luther Enloe........*Secretary*

Early Society Documents

The recently issued Ten-Year Book shows that during the period from 1897 to 1910 the Society printed at least 27 documents of various kinds. These included 12 papers on accounting subjects which were read at meetings of the Society, 7 reports of officers and committees, 2 menu cards of early dinners and 1 stenographic report of the addresses of another dinner, 4 copies of by-laws and lists of members, and the Year Books for 1907 and 1908.

Of these the Society now has copies of only the 2 Year Books, and it seems probable that the others were accidentally destroyed after being placed in storage while the Society had no office of its own. A list of these publications, as prepared from the minutes, but which may not be complete, is given below. If members have preserved any of these or other items the Society will appreciate receiving them in order that as far as possible it may complete its records.

List of Documents Printed 1897-1910

May 10, 1897—By-Laws, 300 copies.
Dec. 1897—Menu Card etc. for Society Dinner.
Oct. 7, 1900—Presidents Report on School of Commerce, Accounts & Finance.
May 21, 1901—By-Laws as Revised with List of Members of the Society.
June 10, 1901—Address by Francis How on The Investigation of Accounts.
Oct. 10, 1901—By-Laws with List of Members.
Nov. 11, 1901—Address by Anson O. Kittredge on The Balance Sheet.
Dec. 12, 1901—Address by Joseph French Johnson on The Relation of Economics to Higher Accounting—500 copies.
Jan. 20, 1902—Address by John L. N. Hunt on Business Training as Demanded by Modern Conditions.
Mar. 27, 1902—Addresses at Dinner on March 19, 1902—1500 copies (also 11/27/03)
Nov. 10, 1902—Report of Delegates to Organization Meeting of Federation.
Dec. 18, 1902—Address by Francis How on Depreciation.
Mar. 9, 1903—Address by Joseph Hardcastle on Two Principles of Accounts and the Bearings they have upon Accountancy.
Oct. 4, 1904—Menu Card, etc. for Dinner at Delmonico's to Foreign Accountants.
Nov. 14, 1904—Report of Committee on Unification of National Societies (Printed?).
May 29, 1905—Stenographic Report of Recent Dinner at Delmonico's.

Jan. 8, 1906—Address by Francis How on Inventories and the Accountant's Responsibility.

Apr. 28, 1906—Treasurer's Annual Report.

June 11, 1906—Twelve-page Pamphlet with Officers, Directors, Members and By-Laws. Report of Committee on Charges for Professional Service.

Dec. 10, 1906—Address by John R. Loomis on Contents and Forms of Executors Accounts.

Jan. 14, 1907—Address by William F. Weiss on Principal and Income, and some Court Decisions of Interest to the Profession.

Feb. 11, 1907—Address by Thomas B. Dean on How to Audit Stockbrokers Accounts.

Apr. 8, 1907—Year Book.

Dec. 9, 1907—Address by Maurice L. Muhlemann on The Central Bank Plan for Remedying our Monetary Evil.

Feb. 17, 1908—Report of Committee on Violations of C.P.A. Law (Printed?).

Mar. 14, 1910—Reports of Committees on Ethics and on Violations of C.P.A. Law.

Arthur T. Spratlin

Arthur T. Spratlin, a member of the Society since June 10, 1910, died on June 23, 1938, at the age of 77, at his home in Pittsfield, Mass.

Mr. Spratlin is survived by his widow, three sons and two daughters.

George M. Sachs

George M. Sachs, a member of the Society since December, 1923, died at his home at 322 Central Park West, after a short illness. He was 53 years old.

He was a member of the American Institute of Accountants, the New York Credit Men's Association, and various other organizations.

Mr. Sachs is survived by his widow, a son and a daughter.

Martin G. Wolf

Martin G. Wolf, of Reading, Pa., a valued and esteemed member of the Society since May, 1922, passed away on February 28, 1939.

Howard Greenman

Howard Greenman, a partner of the firm of Greenman, MacNicol & Co., and a member of the Society since June, 1909, died on January 12, 1939, at the age of 75.

Mr. Greenman was also a member of The American Institute of Accountants.

He is survived by two sons.

The Society has suffered a real loss in the passing of these men who indicated their interest in the welfare and advancement of the accountancy profession by their many years of loyal membership in the Society.

ELECTIONS

The following is a list of applicants admitted to membership and associate membership in the Society and also associate members advanced to membership at the meetings of the Board of Directors held on March 16, 1939 and April 6, 1939, respectively.

March 16, 1939
Membership

Harry D. Anderson, 414 Syracuse Bldg., Syracuse,
With Scovell, Wellington & Co.
Hyman A. Arkin, 1450 Broadway,
Of Climax Audit Co.
James Barringer, 350 Madison Avenue,
With Hurdman and Cranstoun.
Herman W. Bevis, 56 Pine Street,
With Price, Waterhouse & Co.
Emil J. Biza, 19 Rector Street,
With Ernst & Ernst.
Shirland Hitchcock Bouton, 1104 Press Bldg., Binghamton,
Of Forrest E. Ferguson & Co.
James Vallance Collins, 630 Fifth Avenue,
With United States Tobacco Company.
Bernard Henry Dreifoos, 120 Broadway,
With Barrow, Wade, Guthrie & Co.
Arthur Fischman, 500 Fifth Avenue,
With Samuel Fischman & Co.
David Frey, 92 Liberty Street,
With Chambellan, Berger & Welti.
Anthony Frank Gagne, 67 Wall Street,
With C. A. Gall & Co.
Adolph Gartenfeld, 276 Fifth Avenue,
Of John J. Fried & Co.
Arnold Groger, 1776 Broadway,
Of Groger, Kamrass & Co.
Frank S. Harman, 115 Broadway,
With Dominick & Dominick.
Max Horowitz, 233 Broadway.
Hager A. James, 90 Wall Street,
With Farquhar J. MacRae & Co.
Joseph Theodore Klein, 9 East 40th Street.
Jay E. Lenley, 1450 Broadway,
Of Price & Lenley.
Erwin Francis Liegel, Syracuse Bldg., Syracuse,
With Scovell, Wellington & Co.
Irving Malmud, 1457 Broadway.
Arthur James Mannix, 1776 Broadway.
Donald Margolis, 1101 Temple Bldg., Rochester.
Maxwell E. Miller, 570 Seventh Avenue.
Philip Nager, 2 Lafayette Street,
With David S. Pollock.
Philip Nirenblatt, 80 Broad Street,
With Seidman & Seidman.
Max L. Norchick, 251 West 19th Street,
With Hoover Manufacturing & Sales Company.
Edward Paul Pedlowe, 80 Centre Street,
With New York State Banking Department.
Donald P. Perry, 80 Federal Street, Boston Mass.,
Of Lybrand, Ross Bros. & Montgomery.
Solomon Posen, 80 Broad Street,
With Seidman & Seidman.
Robert Hamilton Rexrode, 3280 Broadway,
With Nash Motors Company of New York, Inc.
Alan L. Scheckman, 80 Broad Street,
With Seidman & Seidman.
Jack I. Schneiderman, 11 West 42nd Street,
Norman Silberdick, 562 Fifth Avenue,
Of Leon Rapp & Company.
Irving Evan Singer, 80 Broad Street,
With Seidman & Seidman.
Clay Rice Smith, 111 Broadway,
With National Lead Company.
Harry J. Teitelbaum, 401 Merchants Bank Bldg., Syracuse,
With N. Y. State Unemployment Insurance.
Max Trachtman, 70 West 40th Street.
Frank J. Weibel, 90 Wall Street,
With Farquhar J. MacRae & Co.
Harold Joseph Weimar, 80 Centre Street,
With N. Y. State Banking Department, Liquidation Bureau.
Earle M. Williams, 22 East 40th Street,
With Haskins & Sells.
Clifford Yewdall, 2812 Empire State Bldg.
Albert Ziegler, 22 East 40th Street,
With Saul Levy.
Jacob Zucker, 325 Federal Bldg., Okmulgee, Oklahoma,
With Treasury Dept., Bureau of Internal Revenue.

Associate Membership

Fred J. Buckholtz, 40 Rector Street,
With General Chemical Company.
Morris Arthur Dubrow, Albany,
With State of New York Dept. of Taxation & Finance, Income Tax Bureau.
Joseph Eiger, 245 Fifth Avenue.
William Joseph Fitzsimons, 230 West 41st Street,
With New York Herald Tribune.
Morris M. Goldberg, 1440 Broadway,
Of Goldberg & Haas.
Joseph Hunt, 81 Prospect Street, Brooklyn,
With General Register Corporation.
Jack L. Kessler, 295 Madison Avenue.

Irving Krieger, 17 John Street,
With Max Gross & Co.
William Wein Lazarow, 277 Broadway,
With Samuel Swoff.
Maynard W. Lockwood, 410 M. & T. Bldg., Buffalo,
With Meech, Harmon, Lytle & Blackmore.
David A. MacLeod, 18 East 48th Street,
With Harris, Kerr, Forster & Company.
Edward J. Norton, 480 Lexington Avenue,
With Grocery Store Products Co.
Morris Rauch, 105 West 40th Street,
With Willbach, Black & Company.
Llewellyn Le Roy Rogers, 103 Court Street, Binghamton,
With Brotan's Endicott Corp. and affiliates.
Thomas Degnan Walsh, 80 Broad Street,
With Miller, Donaldson & Company.

Advancement from Associate Membership to Membership

Abraham Ackerman, 1450 Broadway,
With Price & Lenley.
Harold E. Bliss, 414 Chimes Bldg., Syracuse,
With Forrest E. Ferguson & Company.
George William Brunner, 112 Duane Street,
With John Boyle & Co., Inc.
Sidney Cantor, 149 Madison Avenue,
With Oliver & Kaufman, Inc.
Donald Frederic Carroll, 22 East 40th Street,
With Haskins & Sells.
Gerrit De Zeeuw, 105 Hudson Street,
With C. J. Van Houten & Zoon, Inc.
Isidore Dunst, 1 East 42nd Street.
Robert Ira Edelson, 299 Broadway,
With Emanuel M. Edelson & Co.
Julius Fein, 1440 Broadway,
With Harry A. Cummings & Co.
David Feinberg, 38 Park Row,
With Margulies-Fischler & Co.
Morris Feuerstein, 11 Park Place.
Edward A. Flamm, 151 West 40th Street,
With Milton E. Nemerow & Co.
Harold C. Gearing, 347 Madison Avenue,
With J. Edward MacDermott & Company.
Erwin O. Gerhardt, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Harry Gotthelf, Washington & Meadow Streets, Allentown, Pa.,
With Blossom Products Corporation,
William Charles Hawkins, 598 Madison Avenue,
With John J. Donohue.
Abraham J. Heller, 1417 Avenue K, Brooklyn.
Edward C. Holmes, 125 N. Main Street, Port Chester,
With Dusenbury & Hogenauer.
Reuben Jacobson, 342 Madison Avenue.
Harold Ford Jennings, 22 East 40th Street,
With Haskins & Sells.
Leo M. Leuw, 29 Broadway,
With Benjamin Harrow.
James Kenneth Loughry, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Walter McAllister McIntyre, 56 Pine Street,
With Price, Waterhouse & Co.
Peter M. Murray, 551 Fifth Avenue,
With Horwath & Horwath.
Harold V. Petrillo, 67 Broad Street,
With Haskins & Sells.
Frank C. Redfield, 25 W. 45th Street,
With W. C. Heaton & Co.
Francis Daly Reynolds, 56 Pine Street,
With Price, Waterhouse & Co.
Nathaniel Rosenfeld, 140 William Street.
Henry S. Sekerak, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Arlie Grover Smith, 90 Broad Street,
With Lybrand, Ross Bros & Montgomery.
George I. Springsteen, 80 Broad Street,
With Loomis, Suffern & Fernald.
Solomon Telushkin, 38 Park Row.
Joseph J. Volker, 707 Lafayette Bldg., Buffalo,
Of J. D. Elliott & Company.
Charles Wein, 119 West 57th Street,
Of Charles Wein & Co.

April 6, 1939
Membership

Israel Altschuler, 11 West 42nd Street,
With Simonoff, Peyser & Citrin.
Louis Berens, 9 East 40th Street.
Meyer Berger, 1457 Broadway.
Joseph W. Donnelly, 5750 Myrtle Avenue, Brooklyn.
Edvard Fagereng, 150 Broadway.
With Northeastern Water & Electric Service Corporation.
Joseph J. Fischler, 38 Park Row,
Of Margulies-Fischler & Co.
Max Gissen, 67 West 44th Street.
Wallace B. Greene, 1475 Broadway,
Of Samuel Shufro & Company.
Percy Matthew Hendrie, 75 Federal Street, Boston, Mass.,
Of Barrow, Wade, Guthrie & Co.
Moore Peters Huffman, 2 Wall Street,
With Morgan Stanley & Co.
Joseph Gerald Maione, 387 Fourth Avenue,
With Gosnold Mills, Inc.
Paul Neil Marshall, 67 Broad Street,
With Haskins & Sells.
Philip Meisenberg, 551 Fifth Avenue,
With Loewenwarter, Teich & Co.
Harry M. Peritz, 45 Linden Boulevard, Brooklyn.
Edmund Albert Randall, 45 Exchange Street, Rochester,
With Genesee Valley Trust Co.
Louis Joseph Scotto, 598 Madison Avenue,
With John J. Donohue.
Morris Sherman, 157 West 42nd Street.
Irving A. Simson, 475 Fifth Avenue,
With Bernhard M. Joffe & Co.
A. David Sobel, 1440 Broadway.
Elmer N. Sprenkel, 67 Broad Street,
With Haskins & Sells.

Associate Membership

Jacob N. Berson, 220 Fifth Avenue,
With Samuel Berson & Co.
Nicholas Edward Bogus, Municipal Bldg.,
With City of New York.
Archibald U. Braunfeld, 565 Fifth Avenue,
Of Rickman & Braunfeld.
Jesse Bronitsky, 1676 Sterling Place,
Brooklyn.
George Bryman, 11 West 42nd Street,
With Morris Abrams & Co.
Max Jay Chaikin, 11 Park Place,
Of Moscowitz & Rosenthal.
Howard L. Clark, 56 Pine Street,
With Price, Waterhouse & Co.
Irving H. Cohen, 1450 Broadway,
Of Konigsberg, Cohen and Linka.
George Colan, 345 Hudson Street,
With Standard Statistics Co., Inc.
Donald Carl Diehl, 165 Broadway,
With Niles & Niles.
Norman L. Edwardsen, 79 Wall Street,
With Callahan & Fries.
Robert M. Finn, 7 Dey Street,
With Goldsmith & Voorhees.
Nathan A. Friedman, 29 Broadway,
With Robert Siegel and Co.
William Houghland, 56 Pine Street,
With Price, Waterhouse & Co.
James W. Howorth, Jr., 31 Mamaroneck
Avenue, White Plains,
With Hurdman and Cranstoun.
Martin Kalichstein, 370 Lexington Avenue,
With Edwin J. Fluss & Co.
Sidney Kaplan, 271 Madison Avenue,
With Stanley B. Tunick.
Earle William Knopf, 329 Bewley Bldg.,
Lockport.
Alexander E. Langsam, 62-10 Woodside
Avenue, Queens,
With Bulova Watch Co.
Benjamin Levitz, 51 Madison Avenue,
With Aronson & Oresman.
David J. Lewis, 342 Madison Avenue,
With Bureau of Insurance Control, Div. of
Placement & Unemployment Insurance.
Stanley Lutzky, 450 Seventh Avenue,
With A. L. Eolis and Associates.
Irving Mandell, 250 West 57th Street,
With M. J. Weinstein & Co.
Edward J. Martin, 1 Wall Street,
With Irving Trust Company.
Joseph Lincoln Mehr, 60 East 42nd Street,
With Public Service Commission, State of
New York.
Henry Meltzer, 137 Centre Street,
With Thomas E. Dewey, District Attorney.
Max Misthal, 44 Court Street, Brooklyn,
Of Zimering and Misthal.
William Mittler, 270 Madison Avenue,
With New York State Transit Commission.
Edward T. Reilly, 1 Cedar Street,
With R. G. Rankin & Co.
Milton J. Robinson, 3851 Cypress Avenue,
Seagate, Brooklyn.
David L. Rosenberg, 521 Fifth Avenue,
With Herwood & Herwood.
Marcus J. Schaefer, 1457 Broadway,
With Jacob Jagoda.
Joseph Schneider, 257 Fourth Avenue,
With L. Bachmann & Co., Inc.
Oscar Schwarz, 342 Madison Avenue,
With Lord & Lord.
Morris A. Siegel, 3 West 16th Street,
With S. L. Hamburger & Co.
Albert Birtcell Slacum, 34 Greenway Terrace,
Forest Hills.
Albert Sobel, 11 West 42nd Street,
With Joseph Sobel.
Hannah Spanglet, 60 East 42nd Street.
Charles Wallace, 80 Broad Street,
With Clarke, Oakes & Greenwood.
David Wexler, 50 Lafayette Street,
With City of New York,
Office of Comptroller.
Henry A. Wihnyk, 125 Park Avenue,
With S. D. Leidesdorf & Co.
Llewellyn Arthur Wilkins, 31 Mamaroneck
Avenue, White Plains,
With Hurdman and Cranstoun.

Advancement from Associate Membership to Membership

Max Abramowitz, 342 Madison Avenue,
With Benjamin H. Sheft.
Cornelius M. Ahearn, 17 Lexington Avenue,
With The College of the City of New York.
August John Albers, 70 Pine Street,
New York,
With Peat, Marwick, Mitchell & Co.
George Michael Backus, 75 Varick Street,
With Interchemical Corporation.
Henry R. Baltzersen, 56 Pine Street,
With Price, Waterhouse & Co.
Jay Simon Baumann, 51 East 42nd Street,
With S. J. Levenson.
Edward Truman Beckwith, 512 Hills Bldg.,
Syracuse,
With Barrett J. Beckwith.
Martin Behrens, 215 East 149th Street,
Of Behrens & Licker.
Harold S. Benjamin, 270 Broadway,
With Janis & Bruell.
Earle Bryant Brown, 285 Madison Avenue,
With Anchin, Block & Anchin.
Arthur Frank Cooper, 414 Syracuse Bldg.,
Syracuse,
With Scovell, Wellington & Company.
Richard Walter Costello, 120 Broadway,
With Patterson, Teele & Dennis.
Wilbur Melvin Crook, 19 Rector Street,
With Byrnes & Baker.
Alexander Blaikie Dick, 115 W. Dominick
Street, Rome.
William Joseph Doran, 125 Park Avenue,
With S. D. Leidesdorf & Co.
Edward F. Haller, 717 City Bank Bldg.,
Syracuse,
With Stover, Butler, Murphy & Newman.

Howard Leslie Hart, 777 Mt. Read Blvd., Rochester,
With Harold H. Clapp, Inc.
William Julian Heron, 67 Wall Street,
With Pasley & Conroy.
Benjamin F. Hurwitz, 225 West 34th Street,
With Julius S. Auslander.
Julius Jacobs, 5 Beekman Street.
Henry Langsam, 408 East 59th Street.
Albert B. Levine, 210 East 55th Street.
Irving I. Linka, 1450 Broadway,
Of Konigsberg, Cohen and Linka.
Richard Littlefield, 8825-215th Street, Queens Village.
Joseph Daniel McCall, 31 Union Square,
With Richardson & Richardson.
Frederick William Messner, Jr., 22 East 40th Street,
With Haskins & Sells.
Andrew Stephen Mihalik, 25 West 45th Street,
With W. C. Heaton & Co.
Harry E. Milchin, 11 West 42nd Street.
Robert Nathan, 1450 Broadway.
Angelo P. Pagano, 391 East 149th Street.
Francis X. Pryor, 92 Liberty Street,
With Riddle & Camp.
John Parker Ricketts, 56 Pine Street,
With Price, Waterhouse & Co.
Meyer Arthur Shatz, 1440 Broadway,
With Fred H. Herskovitz.
Robert Lamar Spotts, 70 Pine Street,
With Peat, Marwick, Mitchell & Co.
Herman A. Stich, 17 East 42nd Street.
John Henry Thompson, 55 Broad Street,
With Manufacturers Trust Co.
Isidor Tiktinsky, 620 Manida Street, Bronx.
Richard Garret Tilt, 56 Pine Street,
With Price, Waterhouse & Co.
Ira Nelson Tuck, 56 Pine Street,
With Price, Waterhouse & Co.
Alfred W. Tucker, 209 West 125th Street,
Of Lucas & Tucker.
Morris A. Urieff, 521 Fifth Avenue,
With Herwood & Herwood.
Martin A. Weiser, 1150 Brighton Beach Avenue, Brooklyn.
Milton Weiss, 30 Broad Street,
With Nieman & Friedman.
Robert Ormond Wilkinson, 17 East 42nd Street.

The number of members in the Society as of April 10, 1939, is as follows:

Members	2,922
Associate Members..	325
Total.........	3,247

Intangible Assets

UNDER the supervision of William H. Peterson, Jr., Chairman of the Technical Committee on Intangible Assets, the following address was delivered by Mr. T. Reginald Cloake, a member of the Committee. This meeting was the last series of Fall round-table forums held at the Hotel Woodstock on November 30, 1938.

A Discussion of Goodwill

By T. Reginald Cloake, C. P. A.

The fact that goodwill is intangible may lead one to disregard its importance, for we are disposed to consider those assets which are material, and to disregard those which have no physical existence. The latter undoubtedly are more difficult of comprehension, but they are worth consideration. The point to be stressed is that although goodwill is not material, it *definitely exists* as an all important asset.

The opinions on this subject are many and varied. As early as 1571 goodwill was used in its commercial sense and since then accountants among others have formulated many definitions of it. Rules have been prescribed for its accounting treatment and these have been as varied as the definitions.

Harry M. Jay described goodwill as "that intangible, elusive something of questionable, even undeterminable value with which all CPAs have had experience and which is so often the cause of dispute." Although it may be elusive, we shall attempt to grasp it long enough to understand what it represents. By examining various viewpoints, perhaps we shall discover a few new ideas. It should be borne in mind, however that it is as true with goodwill as with most every accounting question, the circumstance of the particular case will govern the treatment.

Once a narrow definition of goodwill may have sufficed, and Lord Eldon's statement in the case of Cutwell *v.* Lye 1810 when he stated that "Goodwill is nothing more than the probability that the old customers will resort to the old place", would have been adequate. With the enlargement of business and its many ramifications goodwill begins to mean something more than just custom, although the latter *must* exist. Let us determine first of all that it is property, and that although intangible, it exists as certainly as the earth on which the business stands. Henry Rand Hatfield goes so far as to say that "there has been produced an element of value quite as important—in some cases, perhaps, far more important—than the plant or machinery with which the business is carried on". George Harris Webber very definitely stated that "the most valuable asset of a business or profession is goodwill—perhaps even more important than capital or credit. Credit to a large degree is based on goodwill and the securing of a loan is nothing more or less than capitalizing goodwill".

The asset of which they speak is that intangible quality of a business which is the very reason for its existence. Business exists for gain and all factors giving rise to the profitable conduct of a business are the very substance of goodwill. A recent issue of "Fortune" described the goodwill of a particular concern as follows, "Yet most of its assets were intangibles—personal relationships, an enormous reputation for business integrity and an understanding of the producers' problems and needs". In our discussion we have already extended somewhat beyond Lord Eldon's statement. Our defi-

nition has been enlarged, not only embracing the favorable attitude of customers but also taking in as J. R. Commons suggests, Industrial Goodwill, the willingness of employees to work for one employer as against competing employers, and Financial Goodwill, the favorable attitude of credit institutions and investors. In addition the Accountants Handbook (W. A. Paton, Edt.) mentions "To these one might add general reputation, public goodwill, and there is also the possibility of having political goodwill—a somewhat questionable condition". I am of the opinion that political goodwill is quite important today, because the absence of political favor might seriously handicap a business, whereas political disfavor is definitely a disadvantage. As a summary definition, I like Edward S. Rogers' best, where he states "Goodwill is that which makes tomorrow's business more than an accident".

It might be mentioned here that other intangibles are of the essence of goodwill. Among these are trade marks by virtue of their trade attraction; patents, trade secrets, and copyrights which by virtue of monopoly give business advantage; and corporation franchise without which the corporate organization and the resultant corporate profits would not exist. However, it must be borne in mind that if goodwill is the reflection of earning power, and if business exists with the above mentioned advantages but still is unable to earn, then the value of the above in a goodwill sense is nil. Another thought too, is that patents and copyrights are definitely terminable, whereas theoretically, goodwill is not.

When we consider goodwill in its broader sense some interesting problems may arise. One such problem appeared in the Journal of Accountancy October 1933. Corporation A buys milk direct from the farmer and bottles it, Corporation B buys all of Corporation A's milk and sells it to retail customers. Corporation A has an established source of supply, Corporation B has an established source of customers. Agreeing that both have goodwill, how may it be calculated?

We come now to the question of how to measure and value goodwill. Having admitted that it exists importantly as an asset, we wish to take hold of it, weigh it, measure it, and value it. But unfortunately we have no fixed scale on which to weigh it and no fixed rule with which to measure it. It is not something for which we might prescribe "ten rules for measuring goodwill".

According to certain theories for measuring goodwill, it may be measured at a particular time, but no one may say that it has any really stable value. It changes from day to day with every change in business fortune and as W. A. Paton stated, "it represents the acme of instability." To measure it, the proverbial rubber rule would come in handy.

If we are to attempt to value goodwill it is important to differentiate between value and price, and it is well to note what Wildman has said on this point, "As to methods of placing a value upon the goodwill in any case, it must of course be admitted that in many instances the figures representing it show price instead of value. Such price may be fixed at what it is expected the prospective purchaser will be willing to pay."

The thought arises here that if goodwill is to be measured by the difference between the value of the tangible assets and the cost price of a going busines, would it not be correct to write off to goodwill the cost of machinery originally purchased as part of the going concern and later found to be unadaptable and discarded?

In valuing goodwill we hear a great deal about super-profits, mean-

ing the ability of a concern to earn something in addition to normal return on its invested capital for that type of business. To attempt to establish a standard base on which super profits or excess earnings might be computed for all types of business, I believe it would be better to use normal interest on capital rather than normal profits. One of the more popular methods of computing goodwill is to capitalize these super-profits at the normal rate of return as already mentioned. Another method of measuring goodwill is that of capitalizing the entire profits and not just the super-profits. Two other methods of calculating goodwill are to determine the earnings of a busines and apply a number of years purchase of the earnings, or a number of years purchase of the excess earnings. Conyngton states that "Courts are fairly uniform as to methods of determining its value—the generally accepted practice is to take the net profits of a business, less 6% on invested capital for a term of years prior to valuation (usually 3 to 5) and obtain the average. Multiply these by the number of years goodwill may be expected to continue". The courts have however suggested varying years of purchase and have not established any definite rule of years therefor.

At best, any method for the valuation of goodwill must be considered to be somewhat arbitrary for we always have debatable quantities to contend with, i.e. normal interest earnings, normal business earnings, years of purchase, etc. The very determination of earning ability, potential earning capacity, may be estimated upon review of past results and in that connection we have to consider the number of years to average, the trend in busines fortune, the effect of change in management, etc. It is probable that some of the goodwill of the present owner may never accrue to a new purchaser. Average profits will have to be weighted for capital employed.

In valuing the goodwill of any enterprise, we should bear in mind what Conyngton says—"On account of its intangible and somewhat illusive nature, goodwill should be capitalized more conservatively than material values."

A recent and interesting treatment of this question was given by Mr. Abe Fortas, Assistant Director of the Public Utilities Division of the S. E. C. in an address before a Legal Seminar in New York on July 14, 1938 in which he stated "In order to test the fairness of a reorganization plan, it is first necessary to arrive at an estimate of value of the property. The primary factor in arriving at this estimate is a capitalization of 'reasonable prospective earnings' * * *.

"Value cannot be determined simply by the application of mathematical formulae. On the other hand, it is not simply a matter of guess work, as some people would like to have us believe * * *.

"There is ever present the problem of determining which earnings figures to take as the basis for a determination of value. Figures for the last available twelve months may not give a dependable answer; nor can one always accept an average of the earnings of several years as the appropriate figure. Reorganizers, and particularly those who are interested in the equity, are always confident that better times lie ahead. It is curious that regardless of their pessimism about the state of the Nation for other purposes, they are always optimistic about the value of their business for reorganization purposes.

* * * "Reasonable prospective earnings does not mean unreasonably possible earnings, although if you look at the forecasts of earnings supplied in a reorganization, you will believe that the two things are synonymous."

Having decided on a value for goodwill the question arises as to how should it be reflected on the books of account. The greater weight of opinion is to record it upon the accounts only when a going business is purchased and then at the purchase cost.—However some accountants are of the opinion that it is proper to record goodwill on the books in other cases. Here, I believe the circumstances will govern the case, and that we should not establish too narrow a rule for recording goodwill. One of the more popular examples of unusual recorded goodwill is the capitalizing of an unusual advertising campaign, i. e. the portion of advertising cost which is believed to create a permanent desire for the product and a permanent familiarity with a trade name or trade mark. Another example is the capitalized cost of establishing various business departments, which it is assumed, will remain in good permanent operating order when once established, thereby creating goodwill in the broader sense. Because it is so difficult to say definitely just what expenditures will be permanently beneficial, it is probably better accounting to write off such expenditures to expense. In a very broad sense, organization expense and early period operating losses are sometimes considered to be in the nature of goodwill.

The occasion might arise when one would be called upon to record goodwill for some particular purpose, as when a liquor concern wished to record its goodwill at the time the prohibition law was enacted in order to show the loss of this goodwill when the law became effective.

Hatfield has an interesting comment on the recording of goodwill—"It is recognized as legitimate for the purchaser of goodwill to include it among his assets, but accounting practice prudently, though illogically, forbids the firm which created the goodwill to place in their balance sheet any value on the clientele which it has built up and which it could at any moment sell for a large sum". As he very nicely phrases it—"conservative restriction prevents harmful exaggeration".

Glaring examples of errors in pricing goodwill at purchase may be found in examining the histories of various businesses, where in cases it will be found that although goodwill was paid for, losses were incurred. We question then, whether goodwill is always properly and honestly recorded. Racine reminds us that "Goodwill is, like the plant account, sometimes erroneously or fraudulently used as a cloak for 'Watered Stock' but it is more proper to use the term 'Discount on Stock' and to frankly state conditions as they are."

A recent suggestion has been to allocate the cost of goodwill to the entire plant assets and by depreciation finally eliminate the cost of goodwill from the books. This is probably on the theory that goodwill is a value which applies to the business as a whole. If we acknowledge goodwill as an intangible value in its own right, and if we agree that it is assumedly permanent in nature, then there seems to be little plausible argument for this unusual treatment.

Once goodwill has been recorded on the books we must consider whether it is to be increased, decreased or finally entirely written off the books. If goodwill were definitely determinable as to value and if the balance sheet purports to show all assets in their true values, then should not the goodwill value be adjusted each year? Theoretically, that may be the perfect solution but from our earlier discussion one may see that it is highly impracticable. If we were to agree that this cannot be accomplished, it is obvious that the goodwill value in the balance sheet would be meaningless in so far as its value at the statement date, and would merely reflect the cost price at the date of acquisition. Should we all

agree that it always remain on the books at the cost price and be so shown in the balance sheet, we would immediately know what it represented or what its absence indicated as far as the history of a business was concerned.

The accounting treatment has not been reduced to so simple a decision, although the consensus of opinion seems to lean slightly toward leaving it on the books at cost price. In this connection Finney very nicely states "Apart from the income tax phase of the subject, it may be said that writing off goodwill is unnecessary and even may be improper—if profits remain stable it creates a secret reserve, if profits have diminished it reduces surplus still further"—The American Business and Accounting Encyclopedia suggests that "The regular amortization of goodwill is not considered imperative, as is the amortization of wasting assets. Such a treatment, however, is not considered objectionable. Strictly speaking, the amortization is a charge against income for the period during which the goodwill is supposedly effective, but the practice of charging capital or surplus instead of current income is approved by accountants".

It is interesting to note here that the Bureau of Internal Revenue's Article 23 of Regulations 94 rules that no deduction for depreciation, including obsolescence, is allowable in respect of goodwill.

As for the accountant's responsibility for showing goodwill correctly in the balance sheet Dicksee covers this point quite completely by suggesting that management should decide whether goodwill should be written down and stating that "The question is not, however, one upon which the auditor is required to express an opinion."

Reducing the value of goodwill on the books perhaps opens the way for accounting manipulation leading to an incomplete disclosure of the adjustments which have been made. A concern might even resort to revaluing assets thereby creating a revaluation surplus to which the goodwill would be written off. With this in mind, it would be better to establish a rule that if goodwill is to be written off, it be written off only to earned surplus. Reducing it to $1 would be better than writing it off completely for the presence of goodwill in the balance sheet at $1 value would disclose the fact that goodwill had existed at purchase and had subsequently been written off.

It is conceivable that some individuals would definitely prefer to have goodwill shown at cost or even at estimated value in a balance sheet and we as accountants should take a liberal view and consider the purposes to which the statement is to be put—we should however qualify our presentation in order to disclose the facts. G. O. May has stated that " * * * it should be obvious that it is not possible to get one form of account or one statement which will serve equally well the purposes of regulation, taxation, annual reporting and a security issue." For the ordinary unqualified balance sheet Dicksee suggests that the goodwill amount in the balance sheet is never supposed to represent its maximum or minimum value, no one is influenced by it and it is meaningless except as an indication of what it cost in the first instance.

In concluding we are again reminded that we cannot arrive at a panacea for all goodwill problems. Viewpoints change with the times and that which we might determine today as being the ultimate in accounting treatment may be changed tomorrow. The ever-changing tax laws have a considerable effect upon our accounting definitions and treatment. Although it may be proper to consider accounting treatment without considering tax treatment, the wise accountant keeps the latter in mind.

Prof. Procedure Securities Exchange act

Reprinted from the April, 1939 Issue of "The Journal of Accountancy" of the American Institute of Accountants.

Testimony of Expert Witnesses at S.E.C. Hearings

ON January 5, 1939, the Securities and Exchange Commission began public hearings at New York before Adrian C. Humphreys, Examiner, for the stated purpose of determining:

1. The character, detail, and scope of the audit procedure followed by the independent auditors in the preparation of the financial statements included with the registration statement and annual reports filed by McKesson & Robbins, Inc., with the Commission;
2. The extent to which prevailing and generally accepted standards and requirements of audit procedure were adhered to and applied by the auditors in the preparation of these financial statements; and
3. The adequacy of the safeguards inhering in generally accepted practices and principles of audit procedure to assure reliability and accuracy of financial statements.

During six weeks the Commission examined many witnesses, representative of McKesson & Robbins, Inc., and the accounting firm which had audited the company's accounts. By February 20th the first stage of the investigation had been completed. On that day the Commission began examination of expert witnesses for the purpose of receiving testimony from a representative cross section of the profession as to what is generally accepted auditing practice and procedure.

Up to this time the examination had been conducted by Irving J. Galpeer, attorney for the Commission. The expert witnesses, however, were examined by William W. Werntz, chief accountant of the Commission.

The testimony of the twelve expert witnesses invited by the Commission to appear had just been completed at the time that this JOURNAL went to press. Following are the names of these witnesses in the order of their appearance:

Samuel J. Broad, of New York
C. Oliver Wellington, of New York
Victor H. Stempf, of New York
William H. Bell, of New York
Norman J. Lenhart, of New York
John K. Mathieson, of Philadelphia
Henry A. Horne, of New York
Charles B. Couchman, of New York
Hiram T. Scovill, of Urbana, Ill.
Joseph J. Klein, of New York
George D. Bailey, of Detroit
Charles W. Jones, of Chicago

The record of their testimony ran to more than 1,500 pages. In order that readers of THE JOURNAL may be given a summary of important parts of the testimony with as little delay as possible, the editors have analyzed the records of each day's proceedings, summarizing the testimony for presentation in a series of articles, of which this is the first. Practical difficulties, however, make it impossible to treat in this issue the testimony of more than the first five witnesses—Messrs. Broad, Wellington, Stempf, Bell, and Lenhart.

It should be emphasized, also, that it is not possible to present in the space available the views of all witnesses on each subject discussed.

Much that is needed to understand fully the views expressed must be omitted. This summary is intended only to indicate the nature of the testimony on the subjects of most general interest.

This month we present:

A general preliminary statement of the purposes and limitations of audits and the responsibility of auditors by the first witness, Samuel J. Broad, of New York. (Mr. Broad was chairman of the special committee of The American Institute of Accountants which prepared the bulletin, *Examination of Financial Statements by Independent Public Accountants,* published by the Institute in January, 1936. Many of the questions asked the witnesses at these hearings are related to statements in that bulletin.)

Brief summaries of opinions expressed so far on several questions on which there was substantial agreement among the witnesses.

Testimony dealing with internal check and control, a review of which is essential to an understanding of much of the later testimony.

Testimony dealing with examination of inventories, treated at length in a separate article in this issue, since this is one of the subjects of investigation most emphasized.

The Nature of Auditing

Following is the text of a general statement read by Mr. Broad at the beginning of his testimony:

"The primary purpose of an accountant's examination for a company which issues financial statements is to satisfy himself that the financial position and earnings are fairly stated. All examination work has as its purpose the confirmation of someone else's expressions of judgment and statements of fact.

"The auditor does this by means of evidence. The evidence falls into three classes:

1. Direct evidence, in which I include: first, documentary evidence, such as agreements, minutes, vouchers, canceled checks; and, second, confirmation of bank balances and bank loans;
2. Circumstantial evidence, e.g., test checks, and beyond that reliance placed on procedures within the organization itself: reliance on internal check and control is based on the belief that if a number of people have had part in initiating, carrying through, and recording a transaction, the transaction is a real one;
3. Oral evidence, i.e., information furnished orally by officials and employees and others in response to the auditor's inquiries.

"The auditor must determine:

1. How much direct evidence he requires and the extent to which he can rely on circumstantial evidence. Certain things are confirmed directly on all examinations. In other cases, as in the case of confirmation of accounts receivable, it may depend on the strength of the circumstantial evidence.
2. How strong the circumstantial evidence should be before he relies on it.
3. How much reliance he should place on oral statements.

"An accountant should not regard his clients with suspicion unless and until circumstances arise which give grounds for suspicion. Perhaps I can illustrate his attitude by a homely example; a policeman walks along the street and as long as everything is quiet he is doing his duty by being watchful and alert; if a crime is committed, however, he does what is immediately necessary and then reports it and a detective is assigned to the case. Similarly, when suspicious circumstances arise, the auditor steps out of his

rôle as policeman into the rôle of sleuth: his procedures are entirely different; the extent of reliance on different classes of evidence is changed materially; he calls for more direct evidence; the circumstantial evidence must be much stronger, and he may reject oral statements entirely.

"Accountants meet varying conditions in business; no two business concerns are exactly alike, and their personnel vary greatly. For example, a treasurer may do in one business what the controller does in another; the controller may do in one case what the chief accountant does in another; there may or may not be an internal audit staff. The size of the concern, the nature of its business, and the extent of the internal check or control determine to a large extent and within very wide limits what should be done before an auditor expresses his published opinion on the financial statements.

"You will accordingly realize that, if you ask me for a common denominator of audit procedures for all classes and sizes of businesses, my answer is more likely to indicate the minimum procedure than the maximum procedure. It would not be fair to state, as commonly accepted procedures for all cases, the standard of what may readily be done by a competent auditor in simple cases. I would like to stress, however, that the minimum is just that—a minimum—and that in the great majority of cases the auditor goes beyond the minimum.

"Uniform standard procedures applicable to all cases could not be laid down by the profession or by any other body, because no such procedures exist or are possible. If they could, the work could be laid out and then be performed by clerks. Instead of being a profession, accountancy would be a routine performance. This is the reason why in New York state certified public accountants now are required to have a college degree, why accountants are required to spend years in training before receiving their degree. Auditing can no more be done by rote than can all bridges be built from a standard blueprint or a lawsuit be tried by formula.

"Any written audit program has as its purpose to guide rather than to lead the accountant, to supplement rather than to supplant the exercise of initiative and judgment."

Purpose of the Bulletin, *Examination of Financial Statements*

There was general agreement among the witnesses that the purpose of the Institute bulletin, *Examination of Financial Statements by Independent Public Accountants,* was to state for the benefit of both the profession and the public what, at the time of its publication, was considered to be generally accepted practice, rather than to introduce new procedures or to make improvements upon old procedures. The program which it outlined, they indicated, was not intended to be applied without variation in all audits, but was to be modified and adapted to the needs of the individual engagement, depending upon the size of the concern, the purpose of the audit, and the relative effectiveness of the existing system of internal check and control. As modified to meet the needs of the individual case, however, most witnesses agreed that it was intended to serve as a minimum program rather than as a maximum. One witness, Mr. Wellington, said that he understood the procedures outlined in the bulletin to represent neither a maximum nor a minimum, but a reasonable requirement: in some cases a more extensive examination might be needed; in others, a less extensive.

Internal Check and Control

In response to questions, the witnesses each said that they expected their staff men assigned to an engagement to become generally familiar with the concern being audited --the plant layout, operating methods, nature of products, character of personnel, etc. The answers indicated that it was general practice for the auditors to prepare or obtain an organization chart or its equivalent indicating the duties and lines of control of personnel engaged in financial and accounting operations.

The witnesses were each asked to define and describe a system of internal check and control. Following are extracts from Mr. Stempf's testimony, which was in more detail than that of the others:

"Internal audit control may be defined as the arrangement of routine whereby the work of each employee is counterchecked by the work of another employee. A complete system of countercheck presupposes an organization large enough to warrant departmental segregation of accounting functions. Complete control of all details is rarely found even in the largest organizations, nor is it suggested because the cost of safeguarding certain types of transactions may be greater than the losses which might arise through the absence of such safeguards. The problem is one of evaluating the hazards and of establishing safeguards commensurate with the hazards.

"Internal check and control should be distinguished from internal audit. The former relates to prescribed routine, whereas the latter term relates to those steps which are undertaken to confirm the effectiveness of prescribed routine. . . .

"Typical of some of the basic features of a system of internal control, it is rudimentary that the functions of cashiering and the maintenance of accounts-receivable ledgers should be separate functional divisions in the accounting department. Bookkeepers engaged on such ledgers should have no connection with the cashier's work and, on the other hand, cashiers should have no access to ledgers nor to statements sent to customers.

"Similarly, in connection with pay rolls, the functions of time keeping, preparing pay rolls and pay-offs should not be controlled under one employee. This work should be performed by different employees or departments and should be checked independently, preferably before pay rolls are released.

"The example most commonly cited relates to what is known as the imprest system of cash funds. Proper control forbids the disbursement of funds emanating directly from cash receipts. All cash disbursements should be made from imprest funds. Under such a system the amount of the fund should be fixed at the smallest possible amount commensurate with the requirements, and reports of disbursements should be made periodically; such disbursements should be reimbursed on the basis of supporting vouchers by checks drawn on the general fund in order to restore the fixed total of the imprest fund periodically."

There was agreement that adequacy of the system of internal check and control has a direct bearing upon the extent to which the auditor should carry his investigation. Mr. Stempf said:

"In my opinion, it has been the accepted practice for many years by public accountants to consider the adequacy of the system of internal control in determining the extent of the examination required to satisfy themselves as to the accuracy of the records. . . .

"In deciding the amount of testing and sampling undertaken by the independent public accountant and in checking the effectiveness of the

system of internal control, the circumstances of each case must be considered. The characteristics of the business, the form of the records, and the use of mechanical equipment are all factors which influence the extent of such examination. The element of judgment is of major importance and the accuracy of the external audit will be affected greatly by the accountant's technique in examining this phase of the work.

"The work of the internal auditor may not be substituted for that of the public accountant, but all evidence which the controller may produce in support of his representations that internal control is effective will influence the extent of the related work undertaken by the public accountant. On the other hand, the periodic examination conducted by the public accountant does not take the place effectively of the constant vigilance of the internal auditing. The two are complementary. The functions of the two should be coordinated to minimize the detailed checking to be undertaken by the public accountant. The reports of internal auditors to the controller with underlying working papers should be retained for review by the public accountant. Such working papers, if properly prepared, will expedite the rechecking of supporting evidence. Similarly, the internal audit staff may lend substantial assistance in the preparation of analyses and assembling corroborative documentary evidence which will facilitate the work of the public accountant.

"I think it should be emphasized that complete systems of internal control and internal audit are rarely found in small and medium-sized companies. Even in the largest organizations, perfect control of all details cannot be accomplished, as the cost involved would probably exceed greatly the possible losses incurred through lack of such control.

"The controlling factor for both large and small enterprises obviously should be to reduce the possibility of loss to a minimum at a commensurate and reasonable cost.

"To demonstrate the necessity for the exercise of judgment in reliance upon internal control and internal audit, I need only point out the wide difference which exists in comparative cases. In a case in which the controller is responsible directly to the board of directors and devotes himself solely to the functions of controller, and where he has under him a competent corps of internal auditors who report directly to him, the degree of independence and reliability of the work done under his direction is quite different from that existing in a situation in which the controller's duties are confused with other functional responsibilities, where he does not have the same degree of independence, where he reports to some other officer of the corporation, and is subject to his instructions, and where he has a limited number of relatively unskilled men at his service in the conduct of the internal audit."

Knowledge of the client's accounting procedure and system of internal check and control may be developed by means of formal questionnaires, inquiries and observation, the witnesses said. It was shown that, although the methods used may vary, the objective is the same: to maintain a file of information which throughout the audit will serve as a guide in decisions as to the extent to which investigation should be carried.

Observation, inquiry, and occasional tests during the course of an engagement should enable the auditor to determine the extent to which the system of check and control is actually followed by the com-

pany's employees, the witnesses agreed. If significant weaknesses are found, they said, additional audit steps are required.

Following is an example cited by Mr. Stempf: An examination of expenditures relating to capital additions and maintenance may indicate theoretically incorrect classifications of such additions, by reason of a failure to observe the distinction between these two classes. In certain cases this might necessitate a protracted examination of additional detail. It may be desirable for the auditor to discuss the subject with the client, and the auditor may even have to convince the client of the necessity for such additional examination and correction.

There was agreement among the witnesses that the auditor's examination of the system of internal check and control should result in a fair knowledge of the accounting system followed by the client, including a knowledge of the kind of documents, vouchers, and other papers used as supporting data.

Disclosure of Fraud

An examination of the financial statements of a corporation whose stock is publicly held does not have as a primary purpose the detection of fraud, the witnesses agreed. It was pointed out that an examination which would protect against fraud would be much more detailed and proportionately more expensive. There was agreement that the auditor should satisfy himself that the client's records are in general accurate and truthful, and the staff men assigned to the engagement should be alert to discover irregularities. Mr. Bell added: "An examination made in accordance with the bulletin [*Examination of Financial Statements*] ought, in my opinion, to disclose any fraud of relatively large amount except perhaps where there has been widespread collusion or forgery of records."

Accountants' Responsibility for Inventories

One of the major topics on which the expert witnesses gave testimony at the hearings of the Securities and Exchange Commission described on page 199 was the accountant's responsibility for inventories. Because of its importance and the space required for its treatment, this subject is here presented under a separate heading. What follows, however, should be read with reference to the explanatory matter beginning on page 199.

Pricing

There was agreement among the witnesses that the auditor should satisfy himself that the inventory has been priced in accordance with generally accepted accounting principles. Questions brought from the witnesses a description of the meaning of the term "market," as used in the phrase, "cost or market, whichever is lower," that market price may be determined by one of two methods depending upon prevailing circumstances: (1) price in the trade in which the product is sold, as determined by quotations from reliable sources, less selling and administrative expenses, or (2) replacement or reproduction cost. It was made clear that the factors to be considered would vary somewhat with different kinds of enterprises and different kinds of products.

In discussion of the phrase "cost or market, whichever is lower," it was brought out that cost may be determined by any one of several generally accepted methods, among them: first-in first-out, last-in first-out, average cost, and normal stock. The testimony showed agreement among the witnesses that the use

of one method rather than another might make an appreciable difference in the inventory amounts shown in the balance-sheet for any particular year if there is a change in market prices of principal raw materials, and would also make a difference in the results of operations shown in the profit-and-loss statement, but that the accumulated net differences would tend to disappear over a period of years. It was pointed out that for this reason consistency in the use of one method is essential and there should be a clear statement of any change in method and the approximate effects of such change. It was not considered necessary to state the basis of inventory cost during periods when the same method is used consistently.

Mr. Wellington was asked the question, "Does the term 'cost' include standard cost, as computed by the cost accounting system of the company?" and the examination continued as follows:

"A. Standard costs are primarily for the benefit of the management, in controlling operations and seeing the efficiency with which the plants are run.

"A standard cost is merely a predetermined cost, what an item should cost, or what is believed to be a fair cost, under current conditions.

"The actual is compared with the standard, and the variance or variances, as to material, labor, and overhead expenses or burden, are usually carried in certain variance accounts.

"At the end of the year, the inventory should be, for balance-sheet purposes, put on practically the same basis as if it were at actual cost; though, if the standard at that time is below actual, many, or possibly most, firms use the standard costs as the most conservative.

"Q. If a company were using standard costs in its balance-sheet for inventory purposes, would you expect them to just say, 'cost or market, whichever is lower,' or 'standard cost,' or what?

"A. The standard cost, unless very far from actual at that moment, is I think perfectly sound to use as 'cost' without explanatory comment."

Goods on Consignment

The witnesses were asked what procedure was necessary to determine that goods held or shipped by the company on consignment are properly treated in the inventory.

As to goods held on consignment, the witnesses agreed that there should be examination of the inventory-control methods and stock records and that, in addition to inquiries of the responsible employees of the company, a statement of ownership should be obtained from the proper company officer. Messrs. Wellington, Stempf, and Lenhart stated that it was their practice to obtain confirmations from the principal suppliers in cases where there were regular transactions of this kind. Messrs. Stempf and Lenhart stated that such confirmations were obtained even though no goods were shown to be held on consignment at the time of inventory taking. Mr. Bell said that principal reliance was put on evidence in the accounts and records and that confirmation or other tests were made as circumstances called for them.

As to goods shipped on consignment, there was agreement that reliance could be put on the evidence of shipping records, correspondence, statements from responsible employees, etc., supplemented by confirmation by consignees of any significant amounts. Mr. Broad felt that, if the items were relatively unimportant, reliance could be put on regular monthly signed statements from consignees. Mr. Wellington felt that confirmation was necessary for complete assurance.

Mr. Stempf and Mr. Lenhart stated that it was their regular practice to obtain confirmations from consignees.

Cut-off

Asked what procedure is followed in determining that there have not been included in sales goods which were shipped during the period subsequent to that under review, the witnesses testified generally as follows: examination of shipping and sales records, in detail, for the period immediately preceding and immediately following the cut-off date; in the case of goods in independent warehouses, reliance upon shipping records received from the warehouse, checked against inventory controls of the company.

Asked what inquiries or tests are customarily made to determine that purchase invoices for stock included in inventories have been entered on the books, they described substantially the same procedure: examination of purchase invoices, receiving records, and inventory records, for the period immediately preceding and following the cut-off date, to see, on the one hand, that items received prior to the inventory date have been taken into inventory and the corresponding liability has been entered on the books, and on the other hand, that items received after the inventory date have been excluded from the inventory.

Qualifications

The witnesses were each asked the following question: Having completed to your own satisfaction the procedure for examination of inventories outlined by the bulletin, *Examination of Financial Statements,* do you include in your report a qualification as to your responsibility for the quantity, quality, or condition of inventories?

Mr. Broad replied in the negative. He said that it was the practice of his firm to request the client to state in the financial statements how the inventory was determined, but that this was not to be considered a qualification. In response to another question, he said that inclusion of such an explanation by the company in its financial statements does not relieve the auditor of responsibility to "make reasonable inquiries and tests to ascertain that quantities have been carefully determined and that quantity and condition have received due consideration," as required by item 3 under inventories in the Institute bulletin.

Mr. Wellington replied that if no examination beyond that outlined in the bulletin had been made, it was his practice to include in his report a clause "accepting the inventory quantities as certified by the president, treasurer, or controller or whoever takes responsibility for them." This he regarded as a definite qualification by the accountant as to his responsibility for the inventory and a qualification of his opinion. A statement to the same effect might also appear in the balance-sheet itself or as a footnote to the balance-sheet. Its presence, he said, would not relieve the auditor from making the tests required by the Institute bulletin.

Mr. Stempf said that he did not consider it necessary for the auditor to qualify his report if an examination such as that outlined in the bulletin had been made. He referred to a resolution of the New York State Society of Certified Public Accountants as defining the auditor's responsibility for inventory and quoted from this resolution as follows:

"If a certified public accountant reports on a balance-sheet of a concern over his signature without qualification or special explanation as to the item of merchandise inventories contained therein, it shall imply that he has exercised care in

his examination by making accounting tests and checks of the concern's books of account and other available records pertaining to merchandise inventory, that he has received all information and explanations he has required from the officers and employees responsible for the taking and valuation of the merchandise inventories and so far as accounting methods permit, has satisfied himself as to their substantial correctness, but that as regards the information and explanations he has required and as to the ownership, physical quantities, description, quality, condition, marketability and valuation of merchandise, he has relied upon the representation of the concern's management subject to such check as may have been obtainable from the records in respect thereto."

Mr. Stempf said, however, that if a qualification as to inventory were to be made, it should appear in the auditor's report rather than in the balance-sheet or a footnote to the balance-sheet, inasmuch as the financial statements and accompanying footnotes and explanations are in the aggregate a representation of the corporation, not of the auditor. He said that in the report, the qualification should be a part of the opinion paragraph, but would not relieve the auditor from responsibility to make the tests required by item 3 of the bulletin.

Mr. Bell's response to the question was that, whenever inventories are a material factor and physical tests of quantities have not been made, a qualification should be included in the auditor's report, but that such a qualification would not relieve the accountant of responsibility to make the tests required by the Institute bulletin.

A somewhat different response to the question was given by Mr. Lenhart, which can be presented better by direct quotation than by summary:

"Q. Now, if the procedure outlined in the bulletin as to inventories has been satisfactorily completed, is it your custom to include in the accountant's report, or the statement, a qualification as to your responsibility for the quantity, quality, or condition of inventories?

"A. We do not customarily include in our report a qualification regarding something concerning which we have no qualification. We believe our responsibility for the quality, quantity or condition of the inventories varies largely as between different types of business. If we make what we consider a reasonable investigation of the quantity, quality, or condition of inventories, we see no reason why we should need to put any qualification in our report. I think there again we would decide for ourselves what would constitute a reasonable examination. If we were examining the accounts of a mining and smelting company, we might look ourselves blind and see huge piles of ores, with no knowledge as to what the value might be. We would be more apt in that case to make all the reasonable tests we thought necessary of book records and production records and feel then that we had done all that we reasonably should do. In some other cases we might feel that a reasonable investigation would require being present when the inventories were being taken.

"Q. In case the accountant's report or the statements indicate that the auditor had relied upon responsible officials for information as to quantity, quality, or condition, do you feel that this avoids the necessity of making any of the tests which are referred to in the last sentence of item 3 . . . ?

"A. I am not at all sure that this condition would arise in our practice. We, at one time, felt that dis-

closure that we did not do something relieved us of responsibility. We have come to feel that if what we didn't do was something we should have done, we are not very much relieved. . . .

"On the other hand, if we had been permitted to make what we consider a reasonable investigation, we see no reason for stating that we have relied upon responsible officials for information as to quantity, quality, and condition of inventories if, in fact, we have not relied only upon such information. Now, in any case, whether physical tests are made or whether they are not, if we feel that we have made what, under the circumstances, is a reasonable investigation into inventories, quantities, and pricing and what not, we see no advantage in the company indicating in its statements either that the inventories are as certified by company officials or in our indicating in our certificates that we have relied on that sort of a representation.

"Q. What do you do when you have not been able to make a test which satisfies you as to its reasonableness in these points?

"A. If the amount involved is not such as to materially affect the statements, we might make a qualification and possibly give some indication as to the amount involved. Our feeling with regard to any material difference is that we should not certify the statements."

Checking Quantities

There followed a question as to what in the opinion of the witnesses were their tests and inquiries contemplated by the last sentence of item 3 of the bulletin, *Examination of Financial Statements*.

Mr. Broad replied by reading from his firm's "Guide for Preparation of Programs," as showing the kinds of checks that can be made depending upon the circumstances.

As to quantities:

" 'Obtain a copy of the company's inventory instructions, and compare with the instructions at the beginning of the period. Make notes of any material changes.

" 'Review the procedure for receiving, recording, and issuing stock.

" 'Prepare comparative schedules showing amounts by which the book inventories at the beginning, during, and at the close of the year were adjusted to physical inventories. Explain material differences.

" 'Test the final inventory sheets by comparison with the originals, and with ticket, cards, or other means used in recording the original count.

" 'Reconcile if possible quantities in inventories at balance-sheet date with quantities in inventories at opening date.

" 'Make a test comparison of the inventories with the stock records, in support of quantities, prices, and values. Investigate differences.' "

As to quality and condition:

" 'Obtain or prepare if practicable statements showing number of months' purchases, or production in inventory, and discuss any item which seems abnormal.' (You would ordinarily obtain that from the stock records. It gives you an idea as to whether there was slow moving stock.)

" 'Inquire if company has discontinued any products, and consider reserve for anticipated loss.' (That is particularly applicable in the case of style goods.)

" 'Apply gross-profit tests by departments, or major products, if possible, and compare gross profits with that of previous periods.'

"The result of tests of this kind will give you a basis on which to go further, if you want to, or to form some kind of a general opinion as to whether these questions of quality and condition have been adequately considered."

Mr. Broad indicated that these tests would ordinarily be made by the senior or supervisor and might be reviewed by the partner.

Asked what tests and inquiries he would make, in accordance with item 3 of the bulletin, if he were not to insert a qualification in the certificate, Mr. Wellington replied:

"Our practice generally is, I believe, somewhat different from other firms, that we, wherever practical, do like to make test checks of the inventory quantities in addition to the mere check of the records."

The examination continued as follows:

"Q. You have indicated there, 'Wherever practical.' What did you have in mind by that?

"A. In certain industries it does not seem to us practical. I might illustrate that.

"Q. If you will.

"A. Take a case like the American Smelting and Refining Company. There the inventories are principally at the various smelters and refineries, scattered geographically as you would expect them to be, and much of the inventory is actually in process in the smelter or refinery. It is controlled by very complete and, we believe, satisfactory records which have been kept for many years. Also the nature of the business is such that the inventories do not fluctuate a great deal and in many cases we have the record of what the company paid the vendor for ores and we know generally what can be expected from them.

"We do not think that examinations we might make would be of sufficient value to the company to justify the expense. That is, to make an examination which would be of any value, we would have to employ a large staff of engineers and metallurgists, and even they would probably not know as much about the inventories as the company's own metallurgists know.

"Q. Would you indicate under what circumstances you do make spot tests to distinguish the type of case?

"A. We have just completed an examination for Revere Copper and Brass, Incorporated. Would you like to have the details?

"Q. Yes.

"A. At the request of the treasurer we spelled out in some detail this year in our report to the directors what we did. May I read it?

"Q. If you care to, yes.

"A. 'We have received certificates from officials at the several divisions of the corporation stating that the inventory quantities were determined by actual count, weight, or measurement, and that adequate provision has been made for imperfect or obsolete stocks.

" 'The physical inventory was taken as at December 31, 1938, by employees of the company, who prepared duplicate prenumbered tickets for the various items in the inventory, retaining the duplicate and leaving the original with the item inventoried. After the inventory count was completed, we accompanied certain executives through the plants, picking up the originals of the tickets, and by various tests satisfied ourselves that the quantities as shown by the tickets were correct. We retained control of the tickets picked up and, upon accounting for all numbers and determining that the inventory had been properly taken, we traced individual items or totals to the inventory summaries prepared from the duplicate tickets. We checked the compilation of the inventory tickets and made substantial tests of the inventories at the fabricating divisions as to metal and product classifications.

" 'In addition to establishing the correctness of the inventories as taken at the plants, we also confirmed with vendors and customers

the quantities of materials belonging to the corporation at other locations or materials belonging to others in its possession. We also checked the mathematical accuracy of the calculations and summaries of the inventory sheets and satisfied ourselves that the prices used were at cost (considering the metal contents of the December 31, 1937, inventory as "cost" for 1938), which in the aggregate was below market.'

"Q. I notice that refers to the balance-sheet as of December 31, 1938. Is that a fair statement of your practice prior to that time?

"A. That has been the practice with this particular client ever since we have done the work, for a number of years. We merely spelled out the procedure at greater length because of recent developments and the opinion of the treasurer that the directors were interested in knowing just what was done.

"Q. Would you have in your certificate any explanation of that?

"A. The certificate is in what might be termed the usual form, but we add a phrase as follows: 'In connection therewith we made sufficient tests of the physical inventories to satisfy ourselves as to their substantial accuracy.'"

At another point the following questions and answers occurred:

"Q. I wonder if you would care to indicate the circumstances, or your feeling, as to whether you should take responsibility for an inventory, or whether you should include in your certificate a qualification such as you have indicated?

"A. We welcome the responsibility where it is in our opinion practical for us to give it such supervision and satisfy ourselves in that way. I think I made the distinction between American Smelting, where we don't think it is practical and Revere, where we do think it is practical.

"Q. Could you give us some other illustrations of where you think it is practical? I mean, general types of industries, if you can.

"A. Where the product is of a nature that those who are not technically familiar with it can satisfy themselves as to quantity and quality and where it can be physically so handled that it can be checked with a reasonable expense. . . .

"Q. Now, as I understand it, you may either put a qualification in your certificate, a qualification on your responsibility for the inventory, or in the alternative you put in this phrase that you have made tests sufficient to satisfy yourselves as to the physical quantities.

"Is the difference between the work that you do in those two cases the question of either supervising the inventory or making physical spot checks of it?

"A. We don't include the phraseology in the certificate unless we do supervise or make sufficient tests of the physical quantities to satisfy ourselves. In either case, we would make checks of the records.

"Q. Yes.

"A. But we don't add that phraseology to the certificate unless in addition to checks of the records we make sufficient tests of the quantities themselves to satisfy ourselves.

"Q. Would you make physical tests such as you have indicated in any cases where you included the qualification?

"A. Not generally.

"Q. And would there be any cases in which you leave out both the stronger language and the qualification?

"A. Yes.

"Q. Under what circumstances would you do that?

"A. Where the system of internal check and the system of records are such that after careful review we are satisfied that the inventory, as stated, is substantially accurate.

"Q. Do you make any physical tests in such cases?

"A. Usually not.

"Q. You rely there on the system of internal control?

"A. Yes.

"Q. But you are sufficiently satisfied with it so you feel no qualification is necessary?

"A. That's right. I have in mind one client with many thousands of items in inventory where they have a stock control which we have tested and checked many times. In my opinion, the inventory determined from those records is probably more accurate than it would be if they took a physical inventory. That is, the possible error in counting, I think, would be greater because they, as part of their routine, have two or more men every day checking certain items. They go through the complete inventory at least once, and usually twice a year.

"I am using that as an illustration to indicate the other extreme where reliance on records, we feel, would be entirely satisfactory, where the client itself relies on the records and never takes a complete physical inventory."

In answer to the same question asked previous witnesses in reference to the last sentence of item 3 of the Institute bulletin, Mr. Stempf replied that the tests and inquiries were those referred to in the New York State Society's resolution, which he had previously quoted, and included "generally such things as the comparison of physical inventory summaries with perpetual inventory records and general ledger controls, a representative comparison of count tags or similar media against the inventory summaries, and the matters which have been referred to in previous questions in connection with the determination of inventory cut-offs."

Mr. Bell stated that "in the greater number of cases in the past, the terms of our engagement has specifically excluded making physical test checks of inventories. By that I mean testing by actually seeing, counting, measuring, or weighing the goods. In cases where this work has not been done by us, we have in the absence of any suspicion of irregularities relied upon documentary evidence and inquiries as indicating that in compiling the inventories the representatives of the company had given due attention to quantities, quality, and condition of inventories, but we have, nevertheless, stated in our certificates something to the effect that the inventories were certified as to quantities, quality, and condition by the officials of the company." He further said that it was the practice of his firm to review the methods followed by the client in taking physical inventory, follow the successive steps taken in the process, and if the methods used appear unsatisfactory, require a recount, the setting up of a reserve against inventory valuation, or in extreme cases qualify the certificate.

Mr. Lenhart had answered this question in responding to the question regarding circumstances under which he regarded qualification of the auditor's report desirable. His views were further expressed in response to a question as to an adequate procedure to be followed by the client in taking physical inventory, which will be quoted later.

Methods of Taking Physical Inventory

Another question called for a statement of the important points in a satisfactory method by which a company may take physical inventory. This was followed by an inquiry as to how the auditor determines that the methods considered satisfactory were actually followed. Because of its full treatment of this subject, Mr. Welling-

ton's testimony is given in its entirety:

"A. One of the most important is proper preparation, that is, proper planning: the decision as to when the plants will be shut down, in what form they will record the information, whether on sheets or tags or tickets, and how the material will be counted or otherwise measured as to quantity by the employees, who will check, and then who will eventually pick up and assemble the primary information.

"Q. Is that done by one or two crews of counters?

"A. Usually by a number of crews, depending, of course, on the size of the business.

"Q. Do those crews cross-check each other in any way?

"A. Not usually. The original count would be made by the employees in the department where the inventory is, and then the cross check would be made by another crew from a different department.

"Q. Is the count by employees available to the crew that comes in to check it?

"A. Usually, yes. That is a question of expense. It is not usually desirable to go to the extra expense of having the second crew count independently.

"Q. How do you establish the observance of these points that you have mentioned by a client? What precautions do you take, or what examinations do you make?

"A. If we are there at the time and supervise the inventory taking, we see what actually happens. If we are not, we make inquiry as to what procedure was followed by the client's employees.

"Q. Of whom do you make such inquiry?

"A. Of the various people involved, presumably starting with the treasurer or controller and working down the line to one or more of the heads of the crews, to be sure that it was carried out satisfactorily.

"Q. Do you customarily supervise the inventory in your practice? Do you do that in any great number of cases?

"A. As many as possible. That is, we prefer to do that if it is practical. Out of all clients of reasonable size, not more than twenty or twenty-five per cent.

"Q. Do you feel that is more satisfactory than some spot checking of inventory?

"A. Yes.

"Q. You indicated it was a question of saving expense, not to have the second crew count independently of the first. How would that saving come about?

"A. The original counting must be done, or should be done, with great accuracy, as that is the record. The crew that comes along to check is merely interested in testing the accuracy with which the first work is done. They would merely make test checks. If they saw a pile that looked either much larger or much smaller than indicated by the ticket, they would either themselves check it or ask to have it reweighed or re-counted.

"Q. They don't actually re-count all of the inventory?

"A. No.

"Q. They simply make a test check of whatever they think looks suspicious?

"A. That's right.

"Q. And would there be any systematic requirement as to test check of certain percentage of each department or each type of item?

"A. I shouldn't think that was necessary.

"Q. Leave it up to the crew to determine?

"A. Yes."

The taking of inventory was described by Mr. Broad in similar terms. In determining that satisfactory methods were followed, he

described the procedure (adopted recently on an experimental basis) of interviewing some of the men who did the work and investigating to see that names and initials appearing on inventory sheets were actually on the pay roll of the company. If the methods were found to be unsatisfactory, the auditor might require a second inventory, though that would be an extreme case. This inventory need not be supervised by the auditor, he said, because "he can rely perhaps on stock records or on tests to satisfy himself, except in a very bad case, whether the inventory is substantially correct, even though it may have been carelessly taken or may not have had the usual steps of internal check and control applied in its taking."

Mr. Stempf's response to the first part of the question dealt largely with the preparation of instructions. He said:

"We endeavor to have a hand in the preparation of inventory instructions and in any event, urge the preparation of instructions relative to methods to be pursued and records to be maintained in taking physical inventory.

"We usually suggest that someone in the controller's department be designated to serve as inventory manager to supervise and direct the physical inventory from the viewpoint of the accounting department. These instructions should include rules concerning cut-offs, physical counts, recording and calculating inventory, provisions for pre-numbering of tickets and forms for the several operations to provide requisite control of the final summarization.

"Such instructions should give attention to goods in transit, on consignment, in public warehouses, out for processing, etc., as well as to defective, damaged, obsolete, or otherwise unmerchandisable goods.

"These instructions should provide for the preparation of schedules from shipping department and receiving department records concerning the effective cut-off of inventory and related adjustments of receivables and payables.

"The instructions should also provide for the preparation of similar schedules relative to purchase and sale commitments, with due regard to questions of market prices in relationship to costs, and with further regard to the relation of commitments to normal requirements, etc."

Concerning the auditor's responsibility to see that these steps were actually taken, he said:

"All of the tests referred to in the preceding questions relating to inventories serve to corroborate the degree to which these provisions have been observed. If we were not satisfied that quantities had been carefully determined and that quality and condition had received due consideration, we would extend the aforementioned test beyond that originally contemplated, to get further assurance.

"We might arrange for recount tests to be undertaken by the client's staff, and in rare cases, in my experience, a complete retake of the inventory has been made.

"This is, of course, a costly step which should be resorted to only in most unusual and extreme cases."

Mr. Lenhart, who had earlier indicated that he preferred assurance of the accuracy of inventory by direct observation or some physical examination, testified as follows:

"A. We review the methods followed by the client in taking the inventory. We think it important that the inventory be first carefully counted and tagged and that a second crew count with the same care as the first crew that pulled the tags. We like to observe the actual inventory-taking to see that the count is carefully made, that all

tag numbers are accounted for before being issued, that all tag numbers are accounted for after the inventory is taken and that the summaries are carefully made and all computations carefully made, and checked.

"Q. Is the count of the first crew available to the second crew at the time they are counting?

"A. I don't think there is any fixed rule. Sometimes it is, sometimes it isn't. The second crew is really checking the count of the first. I see no great disadvantage in having the count available to them. On the other hand, there is the same situation there as in connection with receiving records. If you tell a man what he should be receiving, he might count less carefully and put down the number he should receive rather than the actual number. I would think you would get the most accurate counts by not making the count of the first crew available to the second.

"Q. Is that customary, do you know?

"A. I really couldn't say.

"Q. You stated that you reviewed the procedure purported to be followed. How do you establish that that actually was followed or the observance by the client of those points?

"A. Do you mean in the event that we are not present at the inventory?

"Q. Yes.

"A. We generally satisfy ourselves by examination of the original inventory sheets and by talking to a sufficient number of people who actually participated in taking the inventory. It is rather difficult for a large number of people to tell the same erroneous story and I think if you make enough inquiry you will be able to satisfy yourself as to the methods which were used.

"Q. Now, when you observe the inventory taking, what do you do there? I mean, what does your observation consist of?

"A. We generally would watch some of the counts being made. We would make our own count of a test number of inventory items, keep a record of our counts with the identifying tag numbers and would check those counts against the inventory when summarized.

"We would make a record of the tag numbers issued and the tag numbers taken back and assure ourselves that all tag numbers issued were actually taken back and accounted for."

The witnesses were in agreement that, in appraising the accuracy and integrity of the inventory, the auditor should ascertain and give weight to the nature of the shipping, receiving, and stockkeeping records, and that proper separation of duties among the people responsible for such records is an important part of a system of internal check and control.

Spot Checking

The witnesses agreed that the auditor should be reasonably familiar with his client's products, but some stressed the thought that his knowledge should not be expected to be that of an engineer or technical expert—he should not be expected to pass on salability, obsolescence, or other technical attributes of a product.

There also was substantial agreement that it was desirable, though not to be required, that the auditors make a spot check of the physical inventory to corroborate other evidence of the accuracy of the inventory findings.

Asked whether his firm made such spot checks, Mr. Stempf replied:

"We do. The audit steps which the independent public accountant may apply with respect to the quantities, qualities, and basis of stating the amount of inventories, relates primarily to the evidence which may

be found in the accounting records and underlying documents.

"The independent accountant's secondary line of corroboration of inventories relates to physical inspection. Such physical inspection may lend assurance of minimizing errors, but it should be understood clearly that the technical identification of items is essentially a matter of engineering or appraisal which lies without the scope of the auditor's functions as such. Therefore, whatever the auditor may do with respect to physical inspection of inventories must be recognized as purely collateral and circumstantial, based upon ordinary business judgment and not as vesting ultimate responsibility for valuation, nor of determination of quantities other than those ostensibly identified.

"Based upon this viewpoint, we do make spot tests of inventories by inspection, or actual observation of counting, weighing, or measuring. We do not do so in all cases, but endeavor to apply the principle in some degree wherever possible."

The examination continued:

"Q. You referred there to the technical identification of goods as being a matter for engineers or appraisers, as I understood it. Is that correct?

"A. That's correct.

"Q. Is there any supporting evidence in the customary procedure of an individual concern upon which you could rely without adding an appraisal or engineering report on the identification of particular goods?

"A. I think that's obviously the case, that ordinary judgment would justify reliance upon the prima-facie evidence that a case which indicates that it contains peas as distinguished from beans probably does so, because, substituting something which might be inferior in value to that which the package ostensibly contains would probably be more expensive than to provide the actual merchandise. There are any number of variations of that same principle."

To the same question, Mr. Bell replied:

"A. We believe that in the case of an industrial concern, where inventories have so important a bearing upon financial condition and operations, the reader of the financial statements may reasonably require some assurance from others than the management as to the substantial correctness of the inventories.

"We also believe that in most businesses the public accountant, by reason of his familiarity with the affairs of the company and without being expert in the technical refinements of the business, can serve a useful purpose by physically testing the inventory quantities, thus enabling him together with his other work on the accounts and records to form an independent opinion regarding the substantial correctness of the inventory as a whole. Accordingly, it has been our practice when taking an engagement to have an understanding with our client as to whether or not we were engaged to make physical test inspections of the inventory.

"In some cases we have been permitted to do such work; in other cases we have not. When we have done so, it has been our practice to select merchandise which constituted a fair percentage in valuation of the total inventory and to satisfy ourselves that the goods were actually on hand.

"This we have been able to do in our capacity as accountants without holding ourselves out as experts in the particular industry and without assuming any more responsibility than we assume, for example, in counting securities, as to which we realize and we believe others realize that we may not know whether the securities are genuine or are forgeries.

"In other words, as to inventories, except in rare cases, we find it entirely practicable to identify goods with reasonable satisfaction, relying, of course, to some extent, on information and explanations which we receive from the client's representatives in situations where we believe we are justified in thus relying."

The examination continued:

"Q. In connection with that, Mr. Bell, do you also rely to any extent upon the ordinary course of business of the particular firm? That is, for example, in the case of package goods, you rely upon that in the packages the goods that are supposed to be there are there?

"A. Yes, by observation of conditions. Now, of course, an accountant can be fooled. A package can be utterly empty or can consist of sand instead of something else, but we undertake to use our own judgment.

"Some boxes sometimes will be opened, others will be sounded to see whether they are entirely empty. As a general rule we can get a pretty good idea as to whether we are safe in relying upon labels. Most things are labeled.

"We know that in the ordinary course you see stuff in a stock room, a shipping order comes out, a colored porter goes out and gets a dozen of these things. He doesn't look inside them to see whether there is anything in there or not; he just takes the labels and dumps them on a truck and out they go.

"We think that we can depend upon, in the first instance, people not trying to fool themselves. Of course, there have been situations where we have had reason to believe that people were not so honest as they might be, where we, in some cases, would be very, very careful and go to extremes. We have never, so far as I know, had a situation where there had been any great difficulty in any job that we have ever tackled.

"Now, in testing inventory quantities, we have never had any particular difficulty with descriptions of goods.

"Q. I see. Would you say, then, speaking generally again, that the theory by which you apply spot checks to the records, sampling is equally applicable to inventories?

"A. Yes, sir."

Regarding the practice of his firm in making spot checks, Mr. Lenhart said:

"It is not our invariable practice nor is it our practice in the sense that we always try to do it wherever we might be able to do it. We have some cases in which we may have made physical tests for some years and ceased making physical tests.

"I know of one case where the nature of the business is such and the control over the various branches and plants around the country is such that I would rather rely upon the book inventory record than I would a physical count.

"The quantities involved are yards and the control is so tight that we devote all the time we used to devote to checking physical quantities to checking the accuracy and reliability of this book record."

Mr. Wellington had earlier dealt at length with the methods followed by his firm in verifying physical inventory. On the nature of spot checks and their general desirability, the following questions and answers occurred:

"Q. One further question, Mr. Wellington. When you make a spot check of the physical quantities of inventory, do you feel that that sampling process is an adequate method of verifying, from the accountant's point of view, the total physical quantity?

"A. Yes.

"Q. How would you perform that

spot test? How would you select what to look at or count?

"A. A reasonable number of items, depending on the type of stock, and the facility for checking. It might be anywhere from fifteen to fifty per cent of the items.

"Q. Do you think it would be desirable if auditors should do that in the future, wherever it is practicable,—make some sort of physical verification?

"A. That has been the practice of our firm. I think it is generally desirable.

"The Examiner: Do you select particular items of magnitude, or small items, or mix them up?

"The Witness: Mix them up."

The Examiner asked Mr. Wellington this further question: "In the treating of inventories, do you consider dealings in futures, hedges, and commitments of the client?" to which the witness gave an affirmative answer. The examination continued:

"The Examiner: Do you make a report on those subjects, in instances where that is a common practice? Do you embody that in your report, so that the stockholders, creditors, and others may know their position in respect to futures, hedges, and commitments?

"The Witness: Yes, if there is any probable loss from such a purchase commitment, or other commitment. Where the market has dropped below the price, and there is a potential loss, we comment on it, usually as a footnote.

"The mere fact that the company may have commitments, unless they are unusual in size, would not be commented on, because that is usual in practically every business. Most businesses have some future commitments.

"The Examiner: How about hedges against inventory?

"The Witness: There again, in certain trades, it is a well understood practice.

"The Examiner: Do you comment on that in your report?

"The Witness: Not unless it is unusual."

Over-all Tests

A question was asked as to the use made of over-all tests of the reasonableness of inventory quantities reported. Mr. Werntz particularly mentioned comparison with warehouse capacities, average consumption, trade statistics, imports, tax payments, and insurance coverage. There was considerable difference of opinion as to the effectiveness and reliability of such tests in general and as to the practicability of the individual tests discussed. On the one hand, Mr. Lenhart stated: "It is our practice to make any over-all tests which we believe would afford us any additional assurance as to the integrity of the inventory quantities. If we have made quite extensive test counts, I doubt if we would do a very great deal in the way of over-all tests, and the kind and extent of the over-all tests would depend upon the nature of the business and related circumstances of the case." On the other hand, Mr. Wellington said that it was generally not his practice to make over-all tests of inventory quantities inasmuch as they seldom yielded reliable results. Other witnesses felt that some tests were useful while others were not.

Particular attention was directed by Mr. Werntz to the gross-profits test. Following are excepts from the testimony of several witnesses on this subject:

Mr. Broad

"'Apply gross-profits test by departments or major products, if possible, and compare gross profits with that of previous period.' (Quoted from his firm's "Guide for Preparation of Programs.") . . . If the company shows greater gross profits this year than it did last, let us say, I wonder whether that is because the

inventory is overstated, and if cost of sales is understated. If there is an indication that the inventory may be understated, it is worth looking into, to get a satisfactory explanation."

Mr. Wellington

"I think it has really much less value than would appear. . . . If you have a very simple case where they are making just one product, then it would mean something, but there are very few businesses in which they are making merely one product, and if they are making various products, the relation—the increase or decrease in the proportionate sales of one period as compared with the other—would throw your gross-profit test out of balance."

Mr. Stempf

"We do [employ the gross-profit test] and I say that it is just as often a rule-of-thumb test as it is a reliable corroboration. . . . Broadly speaking, it seeks to corroborate the reasonableness of inventory quantities and to account for and justify variances in gross profits."

Mr. Bell

"Yes, we employ the test and it should be applied to departmental operations whenever ratios vary considerably between departments [rather than on an over-all basis] . . . . The gross-profits test is designed to furnish an indication of the reasonableness of the inventory valuation. This valuation depends upon both quantities and prices. In other words, an unduly high rate of gross profit might indicate an inflation of the inventory as to quantities or basis of valuation."

Mr. Lenhart

"Where there is a great variety of products and profit margins on the products vary widely, it is a rather difficult thing to use the gross-profits test, whereas if you have only one product or if you can break it down by departments, you can generally either find a satisfactory explanation for a variation in gross profit or else you come to the conclusion that inventory is wrong."

Goods in Independent or Vendor's Warehouse

Each of the witnesses said that the quantity of merchandise held in an independent or a vendor's warehouse would be verified by direct confirmation. Whether or not evidence of financial responsibility would be required, said Mr. Broad, would depend upon the materiality of the item involved and other circumstances. He pointed out that there was no risk if the goods had not been paid for by the company, and that cases in which goods paid for were held in any significant quantities in another's warehouse would be very unusual. Mr. Wellington felt that the need for special investigation of a vendor's financial responsibility would seldom arise in practice. Concerning independent and vendors' warehouses, Mr. Stempf said: "Never in my experience have I attempted to independently verify financial responsibility of such (independent) warehousemen, relying upon the judgment and discretion of the operating executives of the client to satisfy themselves in that respect before entering upon such arrangement. . . . As to merchandise left in the hands of vendors at vendors' warehouses, inasmuch as the factor of credit risk is involved, one would naturally consider the offset, if any, reflected in unpaid accounts payable and discuss the subject of financial responsibility of the vendors with the client." Messrs. Bell and Lenhart also said that they did not customarily investigate financial responsibility of independent or vendors' warehouses.

Additional Procedures

The following is quoted from a prepared statement which Mr. Broad read as a part of his testimony:

"Accountants are giving considerable thought to improvements and possible extension of their procedures, particularly with regard to inventories.

"It is probable that more attention will be given to methods of taking the inventory, and to the effectiveness of the internal check and control, as applied while the inventory is in process of being taken.

"Some spot check that the quantities exist is undoubtedly practicable, but however extensive this might be, the auditor, who is skilled in accounts, is not qualified by training or experience to assume responsibility for the quality, description, condition, and salability of the merchandise.

"While he can take steps to assure himself that certain quantities of merchandise are actually on hand, it would be unfortunate if the fact that he took those steps should give the person reading his report a feeling of greater assurance than the facts justify, or should invest the statements in his report, in the words of one of our financial papers, 'With a significance which they neither claimed, nor in fact possessed, nor were designed to offer.'

"A procedure which might be practicable, except in the case of the very large corporations, would be for auditors to be present at the time of taking the inventory, to see that a plan of inventory procedure, carefully thought out and established, had actually in fact been followed; in other words, to undertake general supervision at the time on the spot of the methods of taking the inventory, as distinct from a physical check.

"Another plan which has been suggested is that auditors should encourage throughout the year the continuous taking and checking of parts of the inventories against stock records, or other book records, by employees independent of the stockkeeping departments, and the auditors should follow up the reports on these partial checks.

"I mention these suggestions, not because I think they will necessarily solve the problem, but as indicating that auditing procedures are being carefully considered within the profession. It would be inadvisable to make a hasty and ill considered revision of procedures, or to go to an extreme.

"The problem is to develop existing procedure, so as to give, in added safety, some return commensurate with the increased costs, and perhaps to make a fuller disclosure as to what those procedures are.

"The selfish interests of accountants might be served by insisting on a very much more elaborate program before giving an unqualified report. From a professional standpoint, I believe this would be shortsighted, because, in the long run, what is in the public interest and beneficial to business will be in the sound interests of the profession."

Questioned as to the additional expense of physically checking inventory, Mr. Wellington estimated that it would add "from a quarter to a third" more to the cost of the audit. Examination on this point was as follows:

"Q. What, exactly, did you have in mind there? With what type of inventories would it cost a quarter or third more to make the tests you have in mind?

"A. I want to make clear in the first place that, even where we check inventory quantities by suitable tests, we still make the same examination of the inventory cut-off and check with the receiving and shipping records. We go through the same motions for inventory verification. That is done in the average

case where we don't check inventory quantities but the checking of inventory quantities gives us the additional insurance that the material is there. The work on inventories is a combination of seeing the physical goods and proper checking of the records. The extra cost is for seeing the physical goods and picking up the original tags and tickets and making such tests as are necessary.

"Q. Would you distinguish the cost of supervising the inventory from the cost of going in afterwards and spot checking?

"A. We sometimes do the latter, but only where the work cannot be planned ahead, where we are called in when it is too late. Spot checking after the inventory taking does some good but it is less satisfactory. To accomplish the same results, you have got to do more work.

"Q. Will it be more expensive?

"A. Yes, more expensive.

"Q. And this one quarter or one third estimate refers to the supervision of inventory taken?

"A. That's correct."

Asked what additional procedures to verify quantity, quality, and condition the auditor might use in the future, Mr. Stempf replied:

"I believe that independent public accountants may reasonably extend their tests of merchandise inventories by way of counting, weighing, or measuring, and I should like to reiterate that whatever the auditor may do in respect of physical inspection must be recognized as purely collateral and circumstantial based upon ordinary business judgment and not as vesting ultimate responsibility for valuation nor determination of quantities other than those ostensibly identified.

"The identification of items is essentially a matter of engineering or appraisal which lies without the scope of the auditor. I think that this distinction should be emphasized. I should deplore the creation of an undue reliance by clients, investment bankers, or the investing public upon the fact that the independent public accountant has participated in the physical inspection of inventory.

"Of course, such participation should lend assurance of minimizing error, but must not be viewed as conclusively establishing the technical identification of inventories and the appraisal thereof.

"In the case of inventories in the hands of independent and responsible third parties, I believe direct confirmation from such third parties should continue to be acceptable in lieu of such tests."

The examination continued thus:

"Q. One thing further: Do you think that it would be desirable for auditors to participate in or supervise the actual taking of inventory by their client as distinguished from spot checking after the inventory has been taken?

"A. Within the limitations and from the viewpoint expressed in my answer to the previous question, I believe that it would be desirable for independent public accountants to participate or coöperate in the preparation of physical inventories. There are, however, other practical limitations which relate to this question.

"There are still too many companies which close their books on the basis of the calendar year instead of observing the natural business year for that particular industry. The man power required for effective participation in physical inventories at the calendar year-end is a material factor, an obstacle which is most difficult, if indeed not impossible to overcome. Corporations should be influenced to adopt the natural business year-end and in any event such participation should be had at periods other than at the year-end. I have in mind the extension of the adoption of perpetual-inventory methods by cor-

porations generally which, if effectively maintained, would very largely do away with the necessity of complete physical inventories at any given date.

"The prescribed internal routine should make provision for staggering the corroboration of perpetual inventory records by the determination of physical inventories throughout the year, section by section, or department by department, with provision for effective reconciliation and adjustment of differences to be recorded immediately in perpetual-inventory records and the books under proper authorization and approval of management.

"This method may provide for complete physical inventory two or three times during any given year, and would afford reasonable opportunity for coöperation of the independent public accountant in such physical tests."

Mr. Bell testified as follows:

"I don't see why accountants should not serve the useful purpose of making an independent, reasonable, physical substantiation of inventory quantities. In any case, where quality and condition may be a matter of unusually great purport, it may be desirable to have an expert in the particular industry make an investigation. . . .

"The ideal method of substantiating inventory quantities is to supervise, or observe the process of inventory taking by the company. As I have previously stated, I think this is entirely practical. It is subject, however, as far as general observance is concerned, to lessening the congestion of auditing work at the end of the year by the wider adoption of the natural business year for corporations.

"In this connection, in the case of companies which maintain well kept and controlled perpetual-inventory records, and which take annual physical inventories at the time when their business activities have reached the lowest point of their business cycle — that is, the close of the natural business year—or at other dates not coinciding with the balance-sheet, physical tests could be made by accountants at such other dates supplemented by such review of the intervening transactions to the balance-sheet date and such supplementary physical tests as they consider appropriate."

Examination of Mr. Lenhart was as follows:

"Q. Looking to the future, Mr. Lenhart, would you make any modification in the procedures that auditors should follow as to verifying these items?

"A. Well, if I were trying to get the utmost in audit fees and if I were trying to go as far as I could in the ultimate verification of the last detail, I would go farther than auditors generally now go.

"At the same time, giving weight to the cost of the service and the results that are accomplished day after day with the procedures now used, I think that no particular change is necessary.

"Q. What do you think of the participation of the auditor in taking inventories or by observation?

"A. I think in many cases it is a very desirable thing. As I indicated a while ago I think that in some cases it is either useless or entirely futile for the auditor to try and do anything with an inventory.

"Q. Even to supervise taking of it?

"A. Even to supervising the taking of it, if it is the type of inventory like a mine or smelter where he could go out and do all the supervising and they could either double or triple the inventory while he was standing there and he wouldn't know anything about it.

"Q. In the cases where observation would be valuable, do you think

that that would add significantly to the cost of the audit? What has been your experience rather as to that?

"A. I feel this way, that in the case of very large companies, if we try to survey all the spots and make an extended observation, it would add materially to the cost.

"On the other hand, what I find is that ordinarily the company permits you to make tests or observations at such points as you may select. I think that if you satisfy yourself that things are being done at the point you select and make some variation in the point you select, you have got some basis of being satisfied on inventory methods.

"Q. You would apply the method of sampling to the process of taking inventory?

"A. I would."

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